Chapter 14

Related Party Transactions

Common control in related party transactions exists when business transactions are conducted at less than arm's length between businesses and/or persons that have a family or business relationship. Examples are transactions between family members, transactions between subsidiaries of the same parent company, or transactions between companies owned in whole or in part by the same person or persons.

Reference: 48 CFR 31.205-36 Rental Costs

Paragraph (b) "The following costs are allowable;"

Subparagraph (3) "Charges in the nature of rent for property between any divisions, subsidiaries, or organization under common control, to the extent that they do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, facilities capital cost of money, and maintenance (excluding interest or other unallowable costs pursuant to Part 31), provided that no part of such allowed costs shall duplicate any other allowed cost."

This criteria (cost principle) is used as a basis for rental costs. The principle identifies what is not allowed. Specifically, profit on rental transactions of property and/or equipment between organizations under common control. We find problems with unallowable rental profit being included in overhead rates more often in small businesses than in large ones.

Common Problems

The most common problem found by the auditor is when the consulting firm being audited pays rent for office, laboratory, or warehouse space and/or equipment to another firm owned in whole or in part by the owner, or directly to the owners, or family members of the owner of the consulting firm. WSDOT Audit considers common control to exist when ownership of either firm is put in the name of another family member, such as the spouse or children.

When Common Control is Found

Once common control is found, the auditor will need copies of financial statements and/or tax returns of the rental company. If the rental company has reported a profit, that portion of profit attributed to payments by the consulting firm in common control is unallowable for overhead. Costs that are unallowable in the consultant's overhead rate per FARs are also unallowable in calculating costs of the building.

In the case of space rent, the portion of unallowable profit in overhead is usually determined on a square footage basis. For instance, if 100 percent of available space is rented to the consulting firm being audited, than 100 percent of the profit is unallowable. If only 10 percent of the available space is used by the consulting firm, than 10 percent of the profit is unallowable.

If common control ownership is not 100 percent, than the actual percentage of ownership will be used to calculate the amount of unallowable common control point.

For equipment rentals, the amount of unallowable profit in overhead is determined on a case-by-case basis using a reasonable allocation of costs and revenues between the equipment rented under common control and equipment rented to other firms.

Once the amount of unallowable profit in rental payments has been determined, that amount will be shown as a reduction adjustment on the overhead schedule or to a direct billing charge for services.

Summary

The common control issue is a complex problem. In many cases, input from legal counsel may be required in order to determine the final outcome of audit questions.

Should the auditor become aware of a situation that appears to be a common control issue, numerous questions will be asked. In addition, requests for documentation and information will be made of the firm which may not be considered relevant by the auditee based on their experience with a purely financial type audit.

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